RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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July 1, 1987 **LETTER 968**

June 19 DJIA 2420.85; PTI 2629; A-D Ratio -5.15
June 26 DJIA 2436.86; PTI 2638; A-D Ratio -5.29

THE MARKET: On June 16 it finally happened -- the D-J Industrial Average bettered its April 6 peak of 2405.54, thereby confirming the series of new highs that had already been recorded by the D-J Transportation Average. The action by the Dow reconfirmed the primary bull trend. The Averages are saying, *"It's still a bull market."*

The Dow Theory reconfirmation was followed by new highs in all the major averages including the S&P 500 Index, the S&P 400 Industrials, the NYSE Composite, the NYSE Industrials, and the D-J 65 Stock Average.

But as veteran subscribers know, nothing is ever perfect on Wall Street. The fact is that despite the new high in the Dow, the market action still leaves something to be desired. The problems are technical and have to do with breadth.

For one thing, the record Dow highs have occurred with only a minority of the Dow stocks doing the work. This is seen when we examine the action of the Dow compared with its own advance-decline line (the Dow A-D line tracks the daily differential between the number of Dow Industrial stocks that advanced and those that declined).

The peak for the Dow A-D line was recorded three months ago on April 6. Thus the string of new Dow highs has not (so far) been confirmed by the Dow's own A-D line, and this kind of non-confirmation has often led to trouble.

The other area of concern has to do with the NYSE advance-decline ratio (this ratio tracks the advancing or declining tendencies of all NYSE issues). The A-D ratio has still not confirmed the new high in the Dow. This non-confirmation creates another technical problem and it is one which will worsen through time if it is not resolved (see page 2 chart). The bullish solution would be this: The A-D ratio must advance and better its March 25 high of minus 3.12 in order to confirm the new record Dow high. If it doesn't, the inference is that despite new highs in the major averages, the market is forming a broad and subtle top.

What does it all add up to? The week ending June 19 produced a reconfirmation of the bull market, and that of course is good. But since March we've seen sluggish action on the part of the majority of NYSE issues (as well as AMEX and NASDAQ issues). So the big question is -- can this market straighten itself out and produce A-D figures which are in bullish harmony with the new highs in the leading averages? Or will the lagging A-D pull the market down, despite the "reconfirmed bull market" signal which was produced last week?

From a cold, unemotional reading of the action so far, I draw the following conclusions: (1) It is an obvious plus that the bull market has been reconfirmed; (2) the bull market acts "tired" and many stocks are now lagging or acting listless; (3) the current stock market is overvalued with yields on the major averages currently well below 3% and P/E ratios and multiples over book values far too high; (4) high volume, rumors, the sale of numerous new and untested issues, plus frantic takeover and arbitraging activity indicate that this bull market is in its third and final phase, and (5) regardless of where this bull market is headed, history suggests that a large dose of caution is warranted at this time.

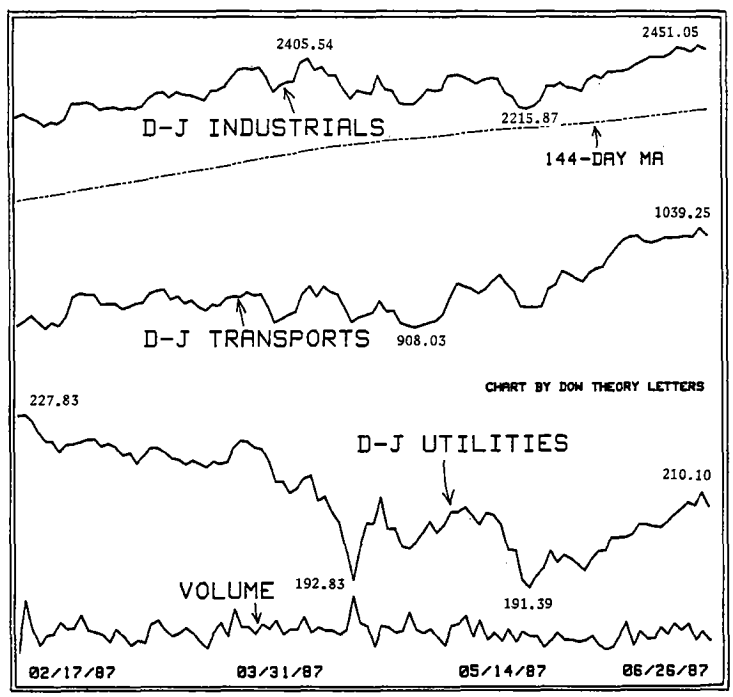
Comment: I cannot emphasize too strongly that the A-D ratio must confirm the Dow and the major averages by advancing to new highs. Most of the important stock market collapses of the past have been prefaced by a persistent refusal of the A-D ratio to advance to new highs in harmony with the Dow.

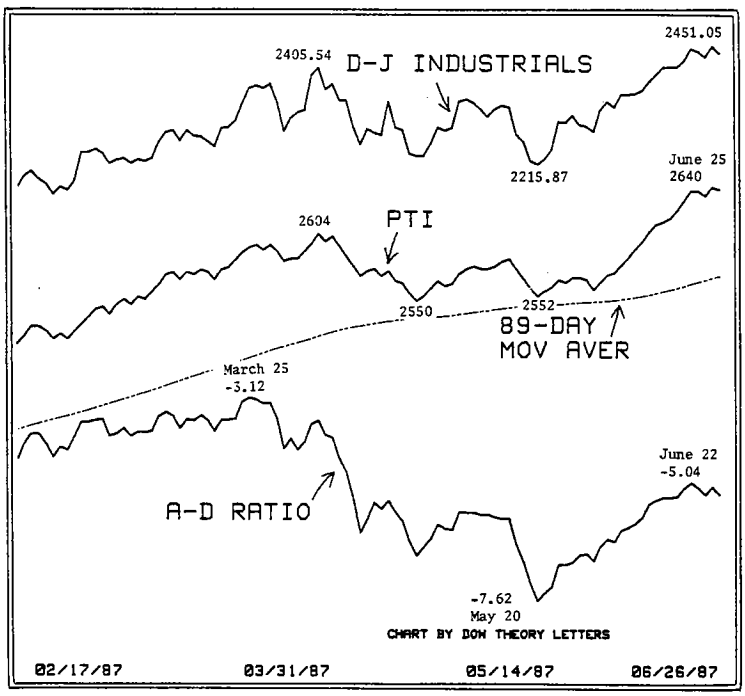
Along these lines, subscribers who own my A-D ratio album may wish to review some recent history such as (1) the January to May 1969 price/breadth divergence which led to the 1970 market collapse, (2) the April to December 1972 price/breadth divergence which led to the 1973-74 bear market, (3) the August-September 1979 price/breadth divergence which led to the 1980 smash, (4) the April-June 1981 price/breadth non-confirmation which gave way to the collapse into August of 1983 and (5) the June to December 1983 price/breadth divergence which led to the 1984 cave-in.

There have also been a few instances where price/breadth divergences have righted themselves. In these rare cases the A-D ratio, after lagging badly, has suddenly gathered strength and rallied to new highs (thereby confirming new highs in the Dow).

We saw this occur during February to June 1976. But the most extraordinary example of this phenomenon took place last year. The A-D topped out in April 1986 and continued lower throughout the rest of the year while the Dow pushed higher. Then during the first three months of 1987 the A-D ratio reversed itself, rallying to a new high (above its 1986 high) while the Dow rocketed higher. But from March 25 to May 20 the A-D collapsed, wiping out almost all of its 1987 gains. And that's where we find ourselves today: The Dow is again pushing to new highs while the A-D ratio is still holding stubbornly below its peaks of both 1986 and 1987.

*I consider the price/breadth relationship to be the **KEY** to the market at this time.*





INVESTMENT POSITION: With a Dow Theory reconfirmation of the bull market and new highs in my PTI, our bull is very much "master of the box." However, the stubbornly lagging A-D ratio and the lack of daily new highs plus overvaluation in stocks are just three of the reasons why I have shorn the bull of one of his horns.

If you've been in the Dow-type stocks (which are the only ones I've recommended) this has been one sensational bull market. If you've been in a collection of run-of-the-mill stocks, you've probably wondered why this bull has even one horn. On a relative strength basis, the AMEX, the NASDAQ, and most of the mutual funds are now lagging the Dow. I think it will continue this way -- until trouble finally arrives.

BONDS & INCOME: Few people understand the idea of risk/reward in investing, and even fewer understand how bonds vs. stocks fit into the risk/reward picture.

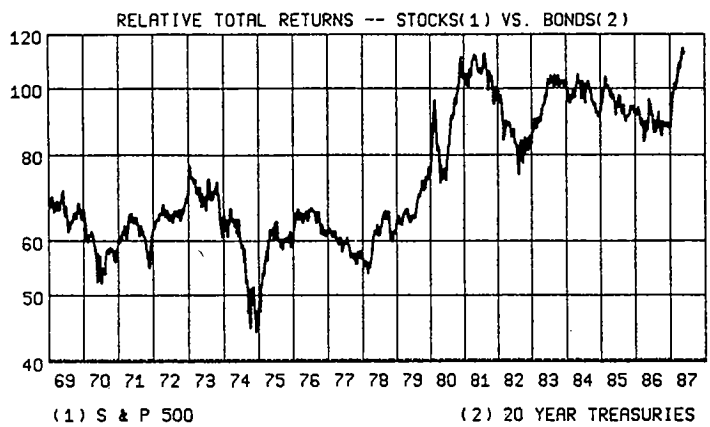
People buy bonds for two reasons: (1) They want the income provided by the bonds; (2) they believe bonds are at an attractive price level and therefore the bonds could appreciate in price, and (3) they like the idea that bonds mature at par or 1,000 -- in other words, they like the idea that they will eventually get their money back.

There are dozens of types of bonds, but let's just talk about one category -- municipal bonds. Personally, I prefer muni bonds to any other category of bonds at this time. I like the munis because (1) when their tax-free features are factored in, munis currently offer a fat rate of return. (2) Munis at this time offer a much higher "after tax" return than common stocks. (3) I believe there is a good chance that income taxes will be increased when Reagan leaves office (the Democrats can't wait to raise taxes), and this favors muni bonds. (4) Muni bonds now offer superior yields compared with other kinds of bonds such as T-bonds.

You have to read the next section with your own state tax code in mind, but I think it is incumbent on all investors to comprehend the logic of the following piece.

Let's take the example of an investor from a high-tax state such as New York or California. For instance, the combined state and federal taxes for a high-bracket Californian run better than 45%. Thus, if we take into account both federal and California state taxes, an 8.0% return on a California muni bond is worth 14.62% to someone like me living here in San Diego and filing a joint return. Therefore, if I buy a muni bond yielding 8.0% and hold that muni for three years, I receive a tax-free amount equal to a 14.62% taxable return compounded over three years or almost 50%. In comparison, if I buy a stock or a taxable bond, that stock or bond will have to bring me a taxable total return of nearly 50% in order to match my 8.0% tax-free muni return over three years.

Now I maintain that a total taxable return of 50% over three years is very difficult for anyone to achieve, particularly with the Dow above the 2400 level. The comparison is this: The Dow would have to push into the 3500-3600 area by 1990 to provide me with a 50% taxable return on my money. Can the Dow do it? Sure, it's possible, but consider this: The muni 8.0% yield is a sure thing, while Dow 3500 is hardly guaranteed.



I'm including a chart (courtesy Smith Barney), and it tells an interesting story. It shows the relative total returns (i.e., appreciation plus interest or dividends) of stocks vs. bonds. The best relative performance for bonds over stocks occurred during 1974 when stocks collapsed while bonds also declined but at much slower rate than stocks. Then the pendulum swung the other way, and by 1981 the ratio went above 115 as stocks performed much better than the collapsing bonds. From 1983 through 1986 the total return on bonds (during the big bond bull market) was slightly better than stocks, and here we see the ratio moving down from 104 to 85.

All of which brings us to the present. The ratio is now back at 118, its highest level since 1981 and equal to its highest level in 20 years. This very high level on the ratio tells me that the ODDS now favor the total return on bonds outperforming the total return on stocks -- at least into the foreseeable future.

Look at it another way. The taxable return on the broad S&P 500 Composite is now 2.9% while the tax-free return on S&P's municipal bond average is currently 7.9%. This means that stocks will have to climb steadily higher over the foreseeable future in order to outperform bonds on a total return basis. Can they do it? Maybe, but the high level of the RATIO on this chart tells me that during the period ahead the odds favor the bondholder rather than the stockholder. That will hold true unless the ratio pictured on this chart is fated to rise into new, uncharted high territory.

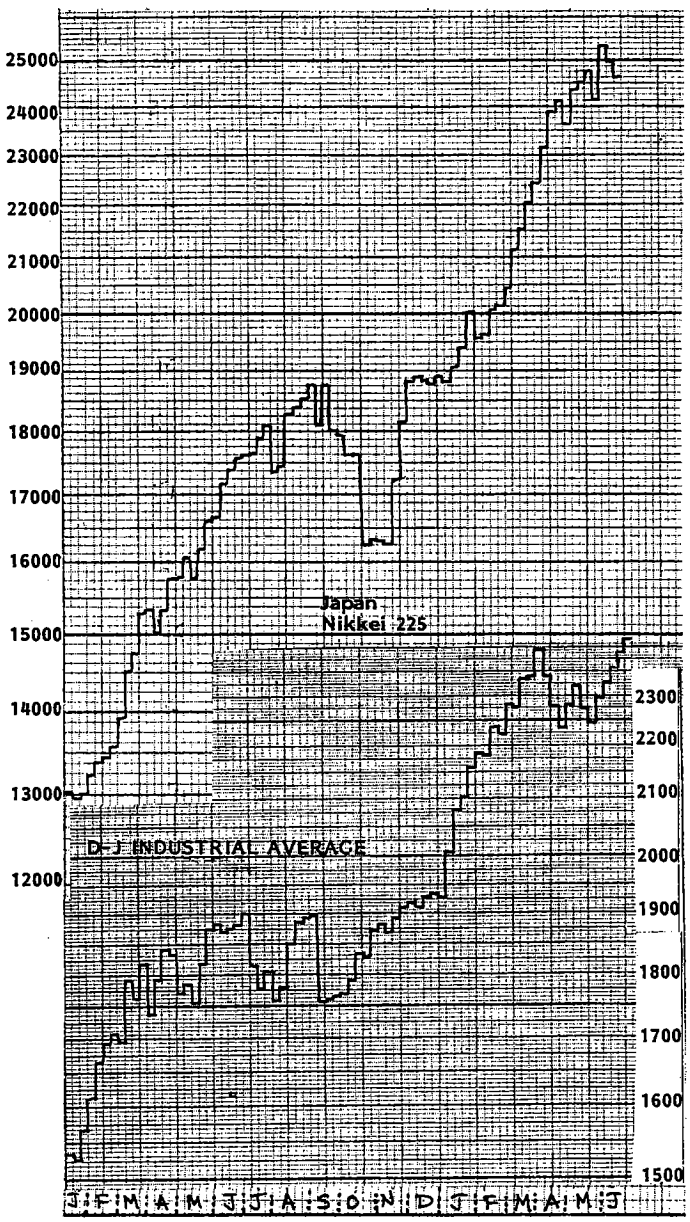
JAPAN and the US: The Japanese economy and the Japanese stock market have become the economic wonders of the Free World. The US is still the strongest nation in the Free World, but today when we say the US is "strongest" we have to limit that statement to the military. The sad fact is that the US is no longer the Free World's strongest economy -- Japan is. How do we know that? Easy, we look at the trade balances. Japan is the producer, Japan is the saver, and it's Japan that is piling up the reserves. The test of a nation's economic strength lies in its manufacturing abilities and its rise (or decline) in reserves. On that test the Japanese have been "beating the pants" off Uncle Sam.

Consider this: The major business excitement in the US is now centered on corporate takeovers and leveraged buy-outs -- both areas of total non-productivity. In Japan the excitement is centered on new products, new industries, and new methods of manufacturing. The fact is that the Japanese are running scared, acting as if they were still a poor nation. Meanwhile, the US is acting complacent, running up deficits, spending money it does not have, and acting as if it was still the richest nation in the world.

All this notwithstanding, recent statistics have some observers wondering. In 1986-87 Japan seems to have put in its weakest performance since 1974. The Japanese official forecast of 4% growth has been revised down by the Japanese government to 3%, and latest figures suggest that the Japanese growth rate may have slowed to 2.5%.

At any rate, it is instructive to compare the stock markets of the US and Japan. I have included a chart of the Japanese Nikkei Average and the D-J Industrial Average. This is a ratio chart, meaning that it deals in percentages. Thus, the two Averages can be correctly compared for extent of move and angle of ascent. Obviously, on both counts the Japanese market has outdistanced the US market.

But there is a problem. The US market is overvalued and the Japanese market is dangerously overvalued. The yield on the Nikkei is less than 1%. Many Japanese stocks are selling at 50 to 100 times earnings. Furthermore, the tax system in Japan militates against taking profits and the areas of investment are very limited in Japan. Thus, huge accumulations of money are funneling into Japanese stocks. From a price standpoint, stocks in Japan are discounting not only the future, they seem to be discounting the "here-after." And with Japan's vitally important position in the Free World's economy, that's NOT a healthy situation (many old-timers, in fact, are comparing today's Japanese market with the US market of 1929).



So I'm watching the Japanese stock market with great interest these days. It's possible that if trouble comes, it's going to start in Japan's feverish (1 billion shares a day traded) stock market. Note how the Dow stalled out in March in the 3% yield zone. Not so the Japanese market, which just kept climbing regardless of the almost non-existent yields.

Of course, there's one major psychological difference in the two markets. US investors have the historic (warning) precedents of the crashes of 1929, 1937, and 1973-74 to think about. The Japanese market knows only "up" and "higher." It's never received its Baptism of Fire. That may lie ahead.

QUESTION: Russell, a few years ago you wrote repeatedly that the US was on a path which would lead it to one of two choices, inflate or die. You have not written about these delightful choices for some time. Would you please update your inflate-or-die thesis?

Answer: In the few years since I wrote that this nation must inflate or die, we have done a little of each. True, the rate of inflation has come down to around 5%, but what about the dying?

Consider this: When Ronald Reagan took over the presidency in 1980 he did so based on an electorate that was sick of big spending and high taxes. So what's happened since? In 1980 federal spending was $590 billion and the federal deficit was $73 billion. This year federal spending will be $1.015 trillion and the deficit will be around $165 billion. I'd call that a bit of dying, at least financially speaking.

How about taxes? In 1980 the US government collected $517 billion in taxes. This year the IRS expects to collect $842 billion in taxes. That's an increase of 62% since 1980. I'd also call that dying a bit, at least if you're a taxpayer.

Remember, all this has occurred during a period without a depression. What happens when a deep recession or depression hits the nation? If that happens, the deficits are going to spiral out of sight, in which case this nation will witness a "financial heart attack." The country, of course, won't actually die, but there will be parallels. I therefore still conclude that the US, on the path that it is following, will ultimately only have the choice of inflate or die.

Question: Russell, what do you make of all these predictions about "the big depression coming up in 1989 or 1990?"

Answer: Frankly, I'm almost tired of the "coming depression" forecasts that we read in the newspapers, magazines, and in the advisory reports. It seems as if a whole industry has been built on "The Coming Crash" thesis. All of which makes me wonder.

And what I wonder is this: what could occur that might trip up both today's perpetual optimists and today's "coming crash" pessimists? Of course, we do know one thing -- bear markets follow bull markets and economic recessions follow economic booms. So somewhere ahead we are going to have trouble. But what kind of trouble?

If I had to guess right now I'd guess that the next bear market, instead of bringing on a dramatic crash, is going to be a long, extended, tedious and costly affair. It's going to be very spotty, very different, with most industries having a tough time but with some industries doing fairly well.

It is well to remember that the bull market since the watershed 1974 low has been a LONG, a very long, bull market. As a rule (based

on history), long bull markets are followed by long bear markets. Therefore, I am wondering whether the next bear market won't be much longer than, for instance, the 1973-74 bear market but (hopefully) not as severe. Anyway, that's the way my thinking is progressing at this time.

Question: The May 25 Barron's published an interesting article entitled, "The Golden Rule, a new way to measure whether stocks are cheap." What did you think of this article?

Answer: That article presented yet another way to adjust the Dow -- this time not for inflation (the current "adjustment of choice") but to the price of gold. The Barron's writer suggested that the Dow be divided by the price of gold. On the basis of this ratio, stocks were cheap (compared with gold) in 1942, 1947, 1948, and 1949. By the same token, stocks were expensive in 1929, 1965, and 1973. The ratio hit an all-time high of 11 during 1972 and 1973, and then headed down to an historic low of 1.43 in 1980 (gold was then 610 and the Dow was 880).

So what do I think? My own feeling is that it is dangerous to adjust the Dow to the price of gold. Let's take an example. Suppose the nation is in peril (for whatever reason) and the price of gold climbs to 1000. A price of 3000 for the Dow would then provide a low ratio of 3 for the Dow/gold ratio. But the Dow at 3000 could represent an absurdly high price for a nation and a stock market in peril.

The flaw in the Dow/gold ratio can immediately be seen. Gold in the past has been a good barometer of the dollar's value in terms of inflation or deflation. But today, gold's price may also reflect fears for the banking system, the global financial system, or the possibility of war. Thus, the Dow's relationship to gold takes on a different meaning today. Consequently, I'd forget about the Dow/gold relationship.

Conclusion: One of the tenets of the Dow Theory states that *the averages adjust for everything except those rare acts of God. Therefore, the Dow needs no adjusting. Stick to that concept and in the Russell opinion you will be better off.*

Question: Russell, I note that you are always berating Congress, blaming our representatives for US spending and deficits. What about the president?

Answer: I fault Reagan as much as Congress for the deficits. Reagan has been a pussyfooter on spending. He's been a big talker and a non-doer. He promised to eliminate the Energy Dept. and the Dept. of Education. The Energy Dept. has never found so much as a barrel of oil, and the Education Dept. has never educated anyone. But both departments are still very much with us.

Reagan talks and talks, but as far as I'm concerned he can keep his talk. What I want to know is where is the Reagan veto? Reagan keeps complaining that he needs line-item veto power (and he does), but he could still use his immense current veto power if he had the political guts (which he doesn't). What this country needs is a Fiorello LaGuardia-type president, a tough, demanding guy who can wield a club, stick with his promises, and if Congress doesn't give him what he was elected to do -- go to the people and get the job done. As far as I can see, Reagan ran up the deficits, messed around with taxes, and has basically left the real work for the next president or the next generation.

Honestly, I like Ronnie, I think he means well. But I'll tell you the truth -- I'm anxious to get him out of there.

NOTES & QUOTES: My old friend, John Magee, died last week at the age of 86. John was one of the great pioneers of technical analysis. John, together with his brother-in-law, Robert Edwards, wrote the classic "Technical Analysis of Stock Trends." Many of us grew up with this book. It is still the bible of chart-reading for individual stocks (the book also contains a great Dow Theory section).

John ran his business out of Springfield, Mass. He was a fine gentleman, a huge help to me and many other market analysts, and he will always live in stock market history. Here's to you John. I don't know what's up there, but I'd bet you're charting it right now.

* *

Is confidence in the stock market high? Is speculation rampant today? In my opinion it is. Consider this: According to the IPO Reporter, 172 small-growth companies, each with less than $50 million in annual revenues, raised $5.2 billion in equity so far this year. Furthermore, 232 more issues (of all sizes) are currently in registration with the SEC and getting ready for sale to the public. Last year small new-issue companies raised a total of $8.9 billion. That figure is almost sure to be surpassed here in 1987.

And talk about rumors -- on June 23 a stock analyst called in to Dow Jones and stated that he was making a $6.8 billion buyout offer for Dayton Hudson. Without checking, the news went out on the wire and the stock jumped 9 points, only to close down for the day when it was announced that the "buyer" was just a mental case who was on his way to the hospital.

* *

NOTICE: Special advance rates for the big San Francisco seminar will be available to DTL readers through July 10. The Seminar will be held Aug. 26-30. For information call 813-955-0323, or see brochure enclosed with this Letter.

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The good news: Remember the Type A personalities that were prone to heart attacks? The National Heart, Lung and Blood Inst. with 12,000 subjects failed to find any connection between Type As and heart attacks. A follow-up on the original study of 20 years ago now finds that although Type As were more likely to have a heart attack, laid-back Type Bs were 60% more likely to have a second heart attack -- and die from it -- than Type As.

* *

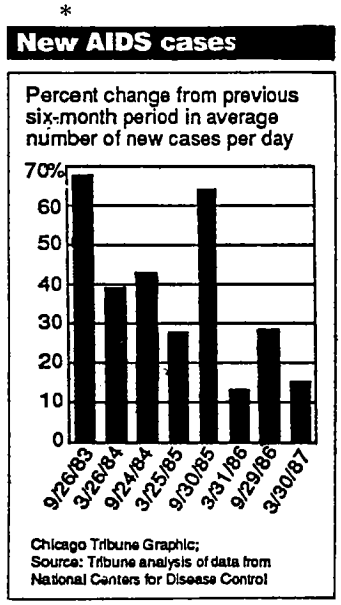
How do you figure? Oil costs the US around $20 a barrel. But taxpayers pay $40 billion a year for the US presence in the Persian Gulf. When you divide that $40 billion by the 330 million barrels of oil we import each year you can figure it costs us $140 for each barrel of imported oil. Ah, those hidden costs!

* *

A couple of years back I recommended a book by M. Scott Peck entitled, "The Road Less Traveled." I still recommend this excellent book which deals with religion, philosophy, and a way of life. But the incredible thing is that this book has been on the New York Times Paperback Best Seller list for 191 consecutive weeks (its nearest competitor has been on the list 33 weeks). Peck has since written "People of the Lie," another fine book, and he is coming out with a new book.

* *

Good news on AIDS for a change -- This chart tells an almost sensational story. Despite what you read and hear, the AIDS epidemic is not expanding exponentially, and the predicted AIDS totals for 1990 and beyond may be very wrong. What we see here is that the growth rate in AIDS cases is declining. Thus the spread of AIDS is NOT in an exponential rise as feared. If the trend in this chart continues, the AIDS explosion could soon level off!



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From our "Everything's a Matter of Timing" Dept: The Chinese have a problem. About 3.7 million Mongols live in China, and China wants to keep them happy. So what are they doing? China is building a million dollar mausoleum to honor a man who was once known as the scourge

of the planet -- Genghis Khan. Genghis and his Mongol hoards conquered all of Asia and most of Europe during the 13th Century. But to the Mongols of today's China, Genghis is a hero.

* *

The Rich: In a recent CIGNA survey of people with annual incomes of over $100,000 and net worths of over $500,000, 82% said that they made the money themselves vs. 8% who said they inherited it. Furthermore, 65% said their net worth increased over the last year. Less happily, the majority thought that Congress will raise the top bracket from the current 28% to 40% by 1992.

* *

I goofed in the last Letter when I stated that Gabelli Fund's symbol is GF -- it's not, it's GAB. Sorry. In the meantime I got a letter from old friend Marty Zweig. Marty's closed-end fund, the Zweig Fund (ZF on NYSE), is another that I like, and I like it particularly because I know that Marty is just as capable of being bearish as bullish. He says in a letter to me that "we're conservative ... we're only 67% in stocks now and 8% in bonds -- the rest is in cash." Marty adds, "Since you and I pretty much agree on the market (a trading range top?), my fund makes sense. If I get bearish enough, we'll go zero or even net short on stocks. We have options, futures and shorts with which we can hedge." As I said, Marty can be bearish or bullish, which is a real novelty among money managers -- and it's a great plus for those who buy or hold ZF, which now sells at 15% below asset value.

* *

The Russians stand in line for everything, thus wasting tens of millions of man-hours each year. But McDonalds may change all that. The fast-food giant believes it will soon be opening its first outlet in Moscow (MCD already earns 24% of its revenues overseas). Pepsi, via Pizza Hut, is also getting ready to open Russian outlets.

* *

Liechtenstein, (population 27,000), situated between Austria and Switzerland, may be the world's best tax shelter (Liechtenstein, it is said, is "where the Swiss go when they want to hide money"). Taxes for foreigners in Liechtenstein are minuscule and local bank secrecy is better than in Switzerland. Liechtenstein, 60.2 square miles in all, is ruled by a 42-year-old prince. The little nation is headquarters for thousands of corporations that mostly serve as centers for untaxed profits from the US, Asia, and the Mideast. Per capita income in Liechtenstein is $16,900, third in the world behind the United Arab Emirates at $19,120 and Brunei at $17,580. The US is fourth at $16,400 and Switzerland is fifth at $16,380.

* *

The Aztecs may have invented basketball, but the blacks are the players. In last week's NBA draft, the first 12 players picked were black. Of the 23 players picked in the first round of the draft, 19 were black.

* *

The glamor days of network broadcasting are over. Last week GE Chairman John Welch, Jr. gave executives at NBC something to think about (GE now owns NBC). Welch advised NBC executives that change was the order of the day. He warned the execs that other managements in other companies owned by GE had been resistant to change and, failing, had been "sent home." Welch continued, "They could not face the change in the world they were in, and nowhere do I feel it as deeply as I feel it in this room. You people in NBC have a deep root to the past." Of course, the changes Welch was referring to were cost-cutting and elimination of the glamor big-spending nonsense which historically has been so much a part of the broadcasting business (Note: CBS, NBC, and ABC have all changed ownership in the past couple of years. All three networks have been losing audiences to VCRs and cable TV, thereby resulting in a lowering of their advertising rates).

Meanwhile, the face of retailing is changing as well. The department stores are now being challenged by the specialty shops, the latter being led by The Gap and The Limited. The Gap, for example, operates 743 stores nationally plus the Banana Republic. Now the Gap is going into higher priced men's and women's clothes with the new Hemisphere stores. They are also going aggressively into children's wear with 12 new GapKids stores. The Limited operates 2,746 stores and is about to open Super Limiteds, stores which will be 15,000 to 20,000 square feet. This year The Limited opened 400 (that's right, 400) new stores.

On the discount front, Wal-Mart is expanding like mad and now serving 23 states and giving the big discounters fits. This year Wal-Mart is going to open Wal-Mart Super Center, huge stores of 150,000 to 200,000 square feet and modeled after the successful hyper-markets of Europe (they will be a combination of grocery and general discount merchandise). Oh yes, there is one hot department store chain, Nordstrom, a tremendous success in the West and now moving east. Actually, Nordstrom is a huge specialty store selling almost nothing but clothes. Nordstrom's secret: merchandise in depth and great service (remember the old days when you used to get service in department stores? Well, Nordstrom gives it now, and the public loves it).

* *

One hundred years from now when they talk about the great film-makers of the 20th century, they'll be talking about Stanley Kubrick. And when they talk about the great anti-war films, they'll be talking about "Full Metal Jacket." It's a milestone in film -- don't miss it.

* *

One of the great industrial enterprises of the 20th century is the Japanese Sony Corp., built from scratch through the foresight and genius of one man, Akio Morita. Recently Morita addressed students at the Univ. of Montana. Here are a few excerpts that are well worth reviewing:

My company's business is to supply electronic products to the world market. Our policy is to make products where the market is. In 1970, we decided to build a factory to produce television sets in San Diego. At the time, it took 360 yen to buy a dollar, so operating costs in the United States were much higher than in Japan. Nevertheless, we were confident that our judgment was a correct one in the long run. We invested, transferred our technology and trained our people. Now our plant in San Diego is exporting TV sets to Japan.

Some people think this is a curious situation. One of my American friends recently said to me, "Akio, I bought an American TV rather than a Japanese TV because we have a terrible trade deficit. I found out later that the American set was made in Taiwan, and the Sony set that I decided I wouldn't buy was made in the United States."

I had to tell my American friend that this situation was not strange at all. What we were seeing was the difference between a company with faith to invest in itself and a company that had no faith in itself at all.

I am afraid that American industry has lost faith in itself, and that the trade imbalance would not be corrected until that faith is regained. The Japanese automobile industry, in particular, is investing heavily in new plants in the United States, creating thousands of new jobs. The American automobile industry, on the other hand, is investing in the Japanese automobile industry not in order to obtain a foothold in the Japanese market but instead to buy engines and even complete automobiles to be sold in the United States market under their own brand name.

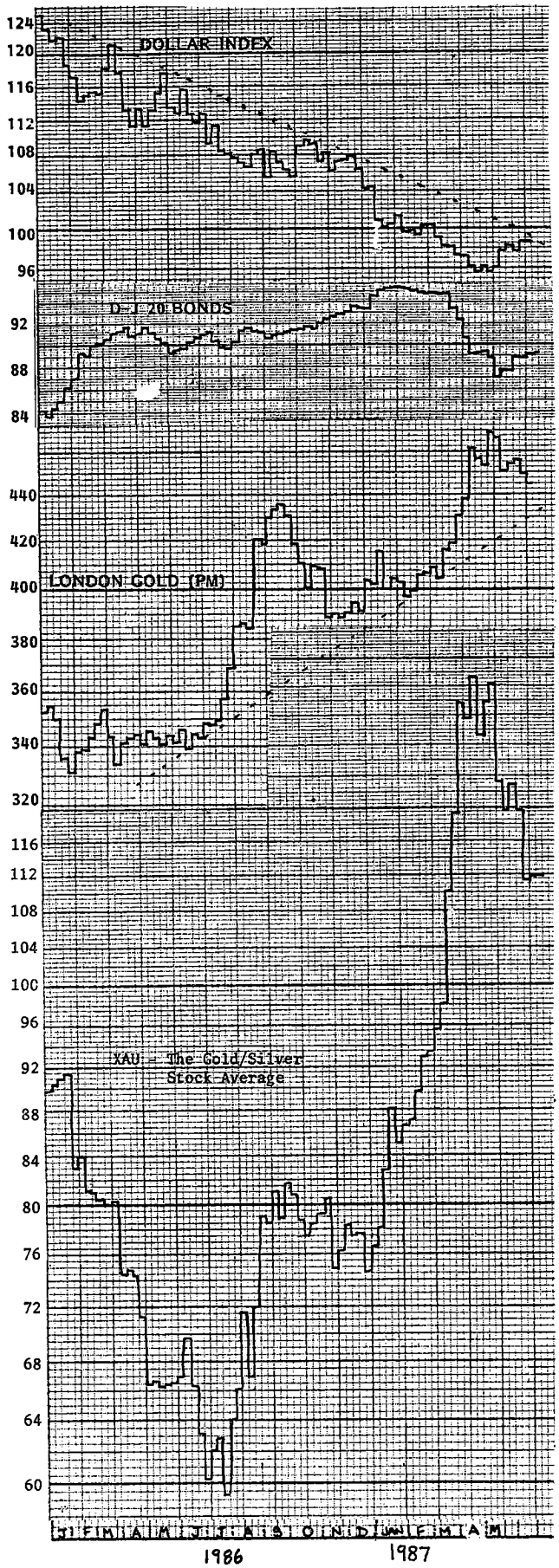
Unfortunately, American industry is now being distracted by a game called mergers and acquisitions. America's brightest managerial talent is engaged in takeover moves and empire-building. The best students do not study engineering but become MBA's or lawyers and, eventually, professional money makers. This is not a productive enterprise.

The big attraction in American business today is the money game, in which profits are made not by manufacturing and selling goods but by guessing whether the dollar will rise or fall against, say, the West German mark in the next 10 minutes. The money game is no doubt exciting, but the swings in the values of the world's currencies that the money game causes makes it impossible for a responsible industry to devise rational investment plans.

America must return to fundamentals, to making things of real value. A business organization's real asset is its people — their good will, their enthusiasm and their creativity. But how can you expect your people to be motivated to work when they are traded like merchandise? A nation's economy is only as strong as its manufacturing base, and this base is chipped away by every mindless merger and by every decision to shift production to a newly developed country only to save on labor.

The world's economy depends on the dollar; the strength of the dollar, in turn, depends on the vitality of American industry. The United States must get back to business. □

GOLD: Let's turn to the chart on page 6. I believe most of the story is pictured right here. The chart is drawn to ratio scale so that all items can be correctly compared. At the top of the chart we see



the dollar index (which is heavily weighted for the mark and the yen). The dollar index, after months of extreme weakness, is looking better. A base has been forming in the dollar, and if this index can climb to 100, I think we will have seen an important turn to strength in the greenback.

The bonds, having swooned during April-May due to inflation scares, are also bottoming. Unlike most observers, I feel that the bond bull market is still intact. I also feel that high-grade bonds probably offer the best risk/reward of any of the investment categories at this time.

Gold has formed a head-and-shoulders top, a top which broke down when spot gold slipped below 445. However, the main support for gold lies at the 400-420 level, and I do not expect gold to go below that area. I also feel, however, that gold is in for an extended rest. There is little inflation today, and I don't see much inflation on the horizon. The recent surge in the CRB Commodities Futures Index (which set off the inflation scare) was based mostly on a "weather bull market" in the grains, and the midwest has finally been getting some rain. As a result, grain prices have dropped sharply, as has the CRB Index.

At the bottom of the chart we see the XAU gold/silver stock average. This average gained an incredible 128% in a period of less than a year, and as a result created one of the greatest stock-group spikes that I've ever seen. Spike advances have a habit of producing very rough corrections, and that's what we've been seeing in the gold and silver shares. I've been warning about this for months; I've also warned that the gold and silver stocks were getting very overpriced. Result: A drop over the last few months of better than 25% in the XAU average and in most gold and silver issues.

Conclusion: I believe the market is telling us that the inflation scare is about over. I further believe that the big problem is apt to be deflation, not inflation. There's a glut of debt and products in today's world. But inflation is created by too much money and a shortage of things. That is not what's happening today.

LATE NOTES: No doubt about it, this is a recently reconfirmed bull market. But it's also a strange market in a number of ways. For instance, when the market declines, it seems to do so with effort. In other words, the market does not go down easily. And that's normally a bullish indication. One simple gauge of this is my PTI, which has resisted on the declines and then pushed to new highs on the rallies.

But the strange part of it is that when the market advances, the breadth is just not there (at least it hasn't been since March 23 when the A-D recorded its bull market high). You can see this phenomenon on the page 2 chart when you compare the action of the Dow and the advance-decline ratio. As I said earlier, neither the A-D for the Dow itself nor the A-D for the entire NYSE have confirmed the new highs in the Dow.

A by-product of the lagging breadth is the dearth of daily new highs on the NYSE. On June 26 the five-day average of daily new highs was 86, a far cry from the five-day average of 176 recorded on January 15. Note: The January 15 average of 176 new highs was the peak for 1987, and it occurred with the Dow at 2070.73 or roughly 360 points below the current level.

Of course all this can straighten itself out, but currently the picture on Wall Street is of a market that is rising on concentrated buying in blue-chip issues while the majority of stocks on all the exchanges lag or follow listlessly behind.

My experience with these kinds of markets in the past is the reason why I am uncomfortable. The whole picture reminds me too much of other periods when the Dow was pushing up in the face of flattening or lagging breadth -- and in retrospect it was seen that a major top was being formed. Let's hope that this time it's different. Only time will tell.

NEXT MAILING: July 15